IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 534

ESTATE OF HENRY W. PUTNAM: GUARANTY TRUST COMPANY OF NEW YORK, Executor,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONER

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(I) SUMMARIZED RESTATEMENT OF THE ISSUE.

The respondent's brief skillfully avoids the critical issue:

> Is the statute to be interpreted as imposing a tax before there is a taxpayer? Was there income at all in this case to be taxed?

This was the issue on which Judge Learned Hand based his conclusion adverse to the respondent. It was avoided by the majority opinion, which relied on authority—the *Enright* case, which applied § 42 to income from personal

services, and decisions of lower Courts in which no *reasoning* had been attempted. We have covered in our opening brief why these authorities do not suffice to resolve this issue.

Let it be agreed that the Congress has constitutional power to impose a tax on the *probability* or *expectation* of receiving income, although never received. Such an exercise of the taxing power must at least be the exception, not the rule. The Court below suggests no reason to impute such an intention to the Congress in this case.

The principal arguments suggested by the respondent are:

(a) That this case is within the evil aimed at by the Congress;

(b) That a dividend is to be assimilated to earnings;

(c) That a dividend is paid out of earnings or profits of the corporation prior to declaration;

(d) That the decedent had a "fixed right" to the dividends.

(a) This case is not within the mischief aimed at by § 42.

That mischief was avoidance of tax, as in cases where income earned during life was held not to be income to the estate, *e.g. Nichols* v. *U. S.*, 64 Ct. Cls. 241; whereas in the case of a dividend income tax *will* be payable by the estate. The dividends here will not (to use the language of the Committee Reports) "escape income tax altogether."

(b) A dividend is of a different character from earnings for personal services.

Earnings for personal services accrue directly to the earner; indeed, as to earnings the usual revenue avoidance problem, if any, arises out of the effort by the earner to short-circuit the Treasury by routing the income direct to a third party. Dividends on the other hand, are from earnings of the corporation, not of the recipient.

(c) Questions as to the earnings and profits of the corporation itself are irrelevant.

For the purposes of income tax law, the nature and source of a dividend is settled by § 115 and the appropriate regulations thereunder. Thus, § 115(b) of the Revenue Act of 1938 states that "every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits." Accordingly, a dividend may be paid from amounts earned after the declaration date (*i.e.*, between the declaration and payment dates, or even to the end of the taxable year of payment, § 115(a)(2)). Indeed, in the case of every corporation that earns anything after the declaration date, the dividend would be paid at least in part from earnings realized after that date.

The fallacy is to confuse the proper accounting rule for the corporation with the income tax status of the shareholder.

If the position of the respondent—that the taxing of the shareholder is a result of the earning by the corporation—were sound, it would tax to the decedent on the date of his death his *pro rata* share of the earnings of every corporation in which he held stock. The respondent certainly does not contend for any such rule; but his

persistence in citing as if relevant the rule of local corporate law that it is on the declaration date that the corporation becomes "indebted", *i.e.* must enter the dividend as a liability (*e.g.* his brief p. 17, also p. 13 note 5 and p. 14 note 6, and p. 20) illustrates his confusion (and the confusion of the lower Federal Courts which had supposed that consideration to be governing, *e.g.* *McGlue's Estate*, 119 F. (2d) 167).*

There was no independent "economic benefit" to the decedent upon declaration of the dividend. He received no warrant, scrip or other sort of disposable right. Before the declaration the share of stock carried its pro rata right to "share" in all earnings of the corporation; and after the declaration it was salable only as a unit, inclusive of the same right. What the respondent calls (at p. 15) "the severance of the amount of the dividend from the general equity interest of the stockholders in the corporate assets" takes place only within the corporation's accounts, and thus again illustrates the persistent confusion in respondent's view.

(d) The decedent never had a "fixed right" to the dividends.

It is a double misnomer for respondent to refer (at p 16) to the decedent as having a right "to receive money at a fixed present time" and then to call that a "fixed right".

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*It is significant that of the cases which respondent purports to cite (in footnote 9 on p. 19) as holding that a dividend "vests" in the stockholder on the declaration date, decisions of State Courts (which alone can be governing under *Erie R. R. Co.* v. *Tompkins* 304 U. S. 64) are found only in New Jersey and New York, and it is recognized that the New York rule may have been changed to conform to the weight of authority and (to us) the true rule.

It is no answer to say, as the respondent's brief does (pp. 6, 25), that the decedent should be taxable on the dividends as soon as declared, since it was in his power to hold the stocks until the record date and receive the dividend. That argument would apply *a fortiori* to a living taxpayer. It would *not* be applicable to a taxpayer who died before the record date.

(II) REPLY TO OTHER ARGUMENTS ADVANCED BY THE RESPONDENT.

(a) The respondent's references to statutory provisions and regulations are not relevant.

(i) *Statutory history.*

A dividend was first defined in the Revenue Act of 1916 (39 Stat. 756). § 2(a) defined a dividend as "any distribution made *or ordered to be made* by a corporation * * * out of its earnings or profits * * * and *payable* to its shareholders * * *". [Emphasis ours.]

The Revenue Act of 1917 (40 Stat. 300) contained in § 1211 the same definition of dividend as was contained in the 1916 Act, but added the provision that any

> "distribution made to the shareholders * * * in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the *distributee* for the year in which *received* and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation * * *". [Emphasis ours]

The Revenue Act of 1918 (40 Stat. 1057) was the first to adopt the familiar definition of dividend now contained in § 115. § 201 of the 1918 Act defined a dividend as "any distribution *made* by a corporation * * * to its shareholders * * * out of its earnings or profits accumulated since February 28, 1913 * * *". [Emphasis ours] In the light of the previous wording of the definition in prior Acts, the use of the term "distribution *made*", while omitting the phrase "distribution * * * *ordered to be made*", represents a Congressional direction that a dividend had to be distributed before it could be income.

In addition, the 1917 Act, although specially providing that a dividend could be taxed only in the year in which received, had taxed that dividend at the rates in force during the years in which it was earned and not the rates in force during the year of receipt. The 1918 Act established the rule that the tax rates in force during the year of *receipt* should control. The Ways and Means Committee Report on the 1918 Act (65th Cong., 2d Sess., H. R. No. 767, pp. 3-4) makes this abundantly clear. It states:

> "* * * The present law [*i.e.,* the 1917 Act] provides that dividends distributed to the stockholder shall be taxable to the individual at the income tax rates in effect in the year in which the dividend is received, unless the corporation distributes more than its earnings for the taxable year, in which case the additional amounts so distributed are taxable in the hands of the individual at the rates in effect during the year in which the corporation earned the same. Under the proposed bill all distribution of earnings accrued since February 28, 1913, will be taxable in the hands of the stockholder according to the rates in effect during the year in which the dividend is received.* * *"

And this Court has already held that the phrase "distribution made" refers to the date of receipt of the dividend. In *Mason* v. *Routzahn,* 275 U. S. 175, Mr. Justice Brandeis, for a unanimous Court, said (at p. 178):

> "Since two of the dividends paid in 1917 were declared in 1916, it becomes necessary for us to consider whether these also are to be deemed *distributions made* in 1917, as it is only to such that the section applies. It declares that the dividend is income of the shareholders in the year in which it is 'received'. We think it clear that, for this purpose, the date of payment, not the date of the declaration of the dividend, is the date of distribution; and as all the dividends here in question were paid in 1917, the provision as to the rate is applicable to all." [Emphasis ours]

An example may illustrate why a single rule taxing all shareholders (regardless of the basis of accounting) on the date of receipt of the dividend is the only workable one:

Suppose that Corporation A, on the accrual basis, owns shares in another corporation. A dividend on those shares is declared on February 1, payable on March 15 to shareholders of record on February 15. Then suppose that Corporation A sells the shares to Taxpayer B, who is on the cash basis. Taxpayer B holds the shares on both the record and the payment dates and receives the dividend. If a dividend "accrues" on the declaration date, Corporation A is taxable on the dividend because it is on the accrual basis. On the other hand, Taxpayer B, who is on the cash basis and has received the dividend, is also taxable thereon. It is no defense for him to say that the price he paid for the stock reflected the value of the dividend. See *U. S.* v.

Phellis, 257 U. S. 156, 176, discussed at pp. 14-15 of our opening brief.

Other absurdities consequent upon the respondent's view may be considered:

Judge Learned Hand in the dissenting opinion below pointed out that a rule that a dividend "accrued" on the declaration date would, when applied to sales of stock by a decedent prior to his death, lead to preposterous results. The respondent attempts to meet that argument by stating (p. 22) that "there would be no occasion to apply Section 42 if the decedent had sold his stock prior to his death." The wording of § 42 does not support the respondent's position. It applies to all items "accrued" during the entire taxable period ending with the decedent's death (in this case January 1, 1938 to March 30, 1938) *or any prior period*. If a dividend "accrues" on the declaration date, there is nothing in § 42 which would relieve the decedent from the income tax thereon because he had disposed of the shares prior to the record date and the new shareholder was also taxed on the dividend.

(ii) *The Treasury Regulations*

The respondent's brief states (p. 27) that the wording of the Treasury Regulation that a "taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands" was originally contained in § 201(e) of the Revenue Act of 1921, but was omitted (as a statutory provision) in subsequent revenue acts. That the Treasury Regulation has been continued without change, shows that the omission of the statutory provision was not intended to change the law.

The decedent in the instant case was *not* the "distributee" which the Treasury Regulations say is to be taxed. The estate *was*.

Article 13 of the Estate Tax Regulations (Treasury Regulations 80), cited at pages 23 and 23 of the respondent's brief, in so far as it is relevant at all, supports the petitioner's position. It provides that "dividends both declared and payable to holders of record on a date prior to the valuation date [date of death], should be separately included" in the gross estate *provided* the stock is valued "ex-dividend" on the valuation date [date of death]. In other words, a dividend will not be considered as a dividend until the record date. As the Circuit Court of Appeals for the Third Circuit said, in *Sharp* v. *Commissioner*, 91 F. (2d) 802, 803:

> "Valuation of the estate assets is the same whether the stock is valued with the dividend or is valued ex-dividend and the dividend debt value is added."

Nor does the quotation from the Conference Committee Report on the 1934 Revenue Bill (referred to at pp. 9 and 10 of the respondent's brief) indicate *when* a dividend accrues. The Report merely states that the decedent would be entitled to a credit, in computing the normal tax, with respect to accrued items "such as dividends". That credit was eliminated in the 1936 Act and was not applicable to the decedent here. The statement in the Report is wholly consistent with the rule that a dividend accrues on either the record date or the payment date, both of which would be prior to the date upon which a cash basis taxpayer would be required to take the dividend into income.

(b) In enacting § 42 the Congress gave no evidence of intent to include items (such as dividends) which under existing law would become income after, but not until after, the death.

§ 22(a) says that "dividends" are income. § 115(a) defines a dividend as a "distribution made by a corporation to its shareholders". The Treasury Regulations have said for many years that a dividend shall not be included in income of the distributees until the "cash or other property is unqualifiedly made subject to their demands." This Court, in *Avery* v. *Commissioner,* 292 U. S. 210, settled that time to be the date of actual receipt of the dividend check.

A dividend, therefore, is just not "income" to anyone within the meaning of the revenue acts until the distribution has been made.

Nor is there any indication that the Congress, in enacting § 42, thought that a dividend was not taxable in the return of the estate where the record date was after the decedent's death. *William K. Vanderbilt,* 11 B. T. A. 291 (1928) and *Frank H. Clark,* 12 B. T. A. 425 (1928) (cited at pp. 8 and 9 of the Commissioner's brief) did not so hold. In the *Vanderbilt* case it does not appear whether the record date was before or after death. In the *Clark* case it appears that the record date was prior to death. Indeed, as the Commissioner points out (at p. 12 of his brief), the Circuit Court of Appeals for the Third Circuit, in *Sharp* v. *Commissioner,* 91 F. (2d) 802, held that a dividend declared prior to the decedent's death was taxable as income of the estate where the record date was after death. The Commissioner has followed that principle in making his assessment to the estate in this case.

And the Third Circuit Court of Appeals, in the *Tar Products* case, 130 F. (2d) 866, applied the rule of the *Avery* case, 292 U. S. 210, *supra,* to an accrual basis taxpayer. The respondent's brief (pp. 27-28) evades the issue whether the rule of the *Tar Products* case is right or not. Respondent does seem to agree that a dividend becomes income at the same time to cash and to accrual basis taxpayers. He draws the conclusion from that statement that the *Tar Products* case did not decide when the dividend "accrued", even though the taxpayer there involved was on the accrual basis of accounting. That is of course meaningless. What the respondent's reasoning comes down to, is that the *Tar Products* case, plus the statute and the Regulation, provide that (regardless of the method of accounting) a dividend cannot be *income* until it is received. With that we fully agree.

§ 42 admittedly set up no new concept of "income". It taxes "amounts" accrued up to the date of death, and the Committee Reports cited in Appendix A to our opening brief confirm that the expression means amounts "of income." § 42 merely required the inclusion in a deceased taxpayer's return of *income* which had accrued up to the date of his death "regardless of the fact that the decedent may have kept his books on the cash basis." Presumably § 42 has no application at all to a decedent on the accrual basis of accounting, and in the case of a cash basis decedent (as in the instant case) does not purport to tax anything which is not the income of the decedent, *i.e.*, items which would be the income of the estate on all bases of accounting —whether cash or accrual.

Under the rule of the *Tar Products* case and *Sharp* case the estate is taxable on the dividend, since it is the

estate's income. Being the income of the estate, it cannot be the income of the decedent.

(c) The respondent has failed to meet our arguments based on accounting principles and business experience.

The respondent still claims (pp. 15-16 of his brief) that the declaration of a dividend is "generally recognized as effecting an increase in the market price of the dividend stock." He says that the mere fact that the market quotations for the stock do not go up does not mean that the market price is not increased. We are unable to follow that argument.

The respondent also argues (p. 15) that the fact that the price of stock drops on the record date by the amount of the dividend confirms the fact that it must have gone up by the amount of the dividend on the declaration date. That is an obvious *non sequitur,* since the price of the stock would gradually go up as the earnings of the corporation were accumulated, and the mere identification on the declaration date of two sticks in the shareholder's "bundle of rights" would not affect the value of the stock as such.

The respondent's brief cites (p. 26) certain accounting authorities which he claims are to the effect that a dividend should be "accrued" as soon as declared "even though a record date may be involved." None of the authorities he has cited however refer at all to a record date. They involve mainly the distinction between dividends and interest, and are uniformly to the effect that a dividend should not be accrued before it is payable.

The Commission orders (pp. 26-27) have reference to a different purpose. A corporation holds shares in another corporation generally on a long-term investment basis; and

the motive behind the rules of the S. E. C., F. P. C., I. C. C., etc. is to avoid concealment of income whose receipt is *probable* and *expected.*

(d) Nor do the miscellaneous legal authorities which the respondent has cited support his view.

Even among the decided cases, none until the present has ever indicated that a dividend accrues differently to a decedent than to anyone else. *Bach* v. *Rothensies,* 124 F. (2d) 306 (C. C. A. 3d), cert. den. 316 U. S. 666, cited at page 12 of the respondent's brief, is not to the contrary. That case did not present the question of when a dividend accrued. It was assumed there that the dividends in question had accrued to the trustee-holder of the stock. The case was decided about a year prior to *Tar Products Corporation* v. *Commissioner,* 130 F. (2d) 866 (C. C. A. 3d) which held that a dividend could not, under the express terms of the revenue laws, accrue before it was received.

The respondent's effort to support his position has led him to some curious inconsistencies. On page 25 of his brief he states that the dividends must be deemed under "principles of accrual accounting" to have accrued when they were declared, citing for that proposition the Board of Tax Appeals decision in the *Campbell* case, 6 B. T. A. 60. Then, on page 28, he tells us that the *Campbell* case has been overruled in *Koppers Co.,* 3 T. C. 62, and *American Light & Traction Co.,* 3 T. C. 1048.

So also, he agrees (p. 13) that the question of when a dividend accrues should be decided by a uniform Federal rule, and that the State law concepts of when a dividend vests in a stockholder are not controlling. However, on

pages 18-19 he cites a multitude of State Court cases with respect to when a dividend becomes a debt or vests in the shareholder, but admits that the rule is not the same in all States. Since he has already admitted that State law is not controlling, we fail to see why he has cited the State cases at all. They are not helpful to the decision of this Federal question.

Respectfully submitted,

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